STATE OF WISCONSIN
DEPARTMENT OF EMPLOYEE TRUST FUNDS
801 West Badger Road
Madison, WI 53702

CORRESPONDENCE MEMORANDUM

DATE: May 30, 2002

TO: Employee Trust Funds Board
Wisconsin Retirement Board
Teachers Retirement Board

FROM: Robert Willett, Director
Controller's Office

SUBJECT: December 31, 2001 Financial Report

Attached are the financial reports as of December 31, 2001 for all benefit plans administered by the Department of Employee Trust Funds. The reports show comparative income statements and balance sheets for 1997 through 2001. Data for 1997 through 2000 is from the final audited financial statements. The 2001 **data is preliminary**, and in some cases incomplete. Some 2001 data is based on annual close-out processes and actuarial valuations which are not yet complete. In those cases, estimates have been incorporated into the statements. In situations where estimates could not be reasonably determined, or where the amounts are immaterial and do not affect the overall usefulness of the financial report, data has been omitted from the report.

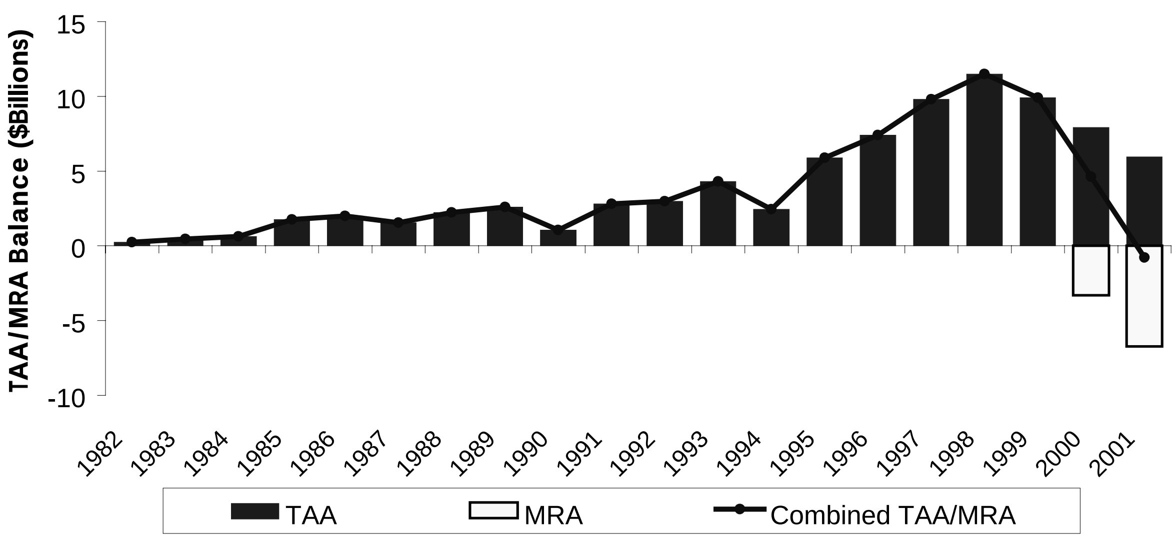
I've also included some additional explanation of selected data in the statements which may need further clarification, or that you may find noteworthy.

Because of a scheduling conflict, I will not be able to be at your June 20 meeting to discuss this report. Our new Chief Accountant, Jerry Dietzel, will be presenting the report in my place.

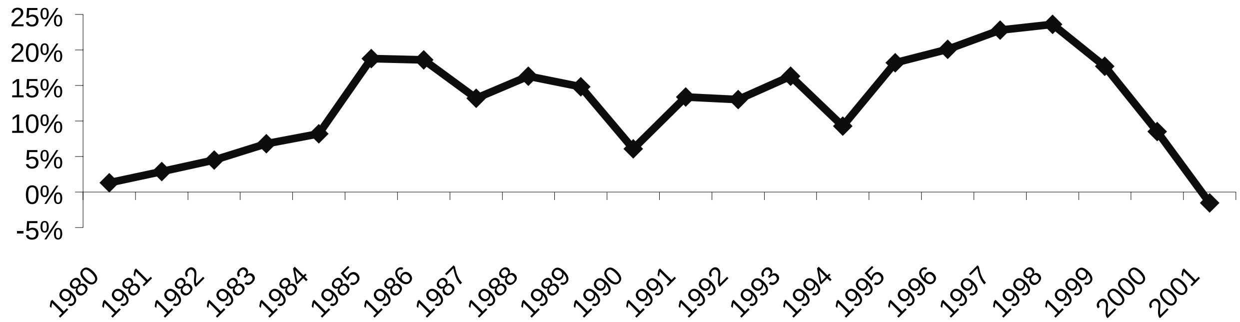
Transaction Amortization Account
Market Recognition Account

The transaction amortization account (TAA) and market recognition account (MRA) are reflected as a reserve for market value adjustments in the financial statements for all of the programs invested in the fixed retirement investment trust, including Fixed Retirement, Police & Firefighter Retirement, Milwaukee Special Death Benefit, Income Continuation Insurance, Duty Disability Insurance, Accumulated Sick Leave Conversion, and Long-Term Disability Insurance.

The charts below shows the year-end balance, after annual distributions, of the TAA and, beginning in 2000, the MRA, as well as the TAA / MRA as a percent of the total fixed trust funds. These charts illustrate the steady growth of the TAA over many years, and its rapid depletion following the Act 11 distribution, the conversion to the MRA, and the market downturn. 1998 was the all time high year-end TAA balance ($11.5 billion) and the balance as a percent of the total fixed trust fund (23.6%). 1999 would have exceeded the 1998 balance in actual dollars and as a percent of the total fixed fund if Act 11 hadn't recognized $4 billion in a special year end distribution. At the end of 2001, the combined TAA / MRA had a negative balance for the first time since the 1970s.



Combined TAA / MRA as % of Fixed Trust Fund



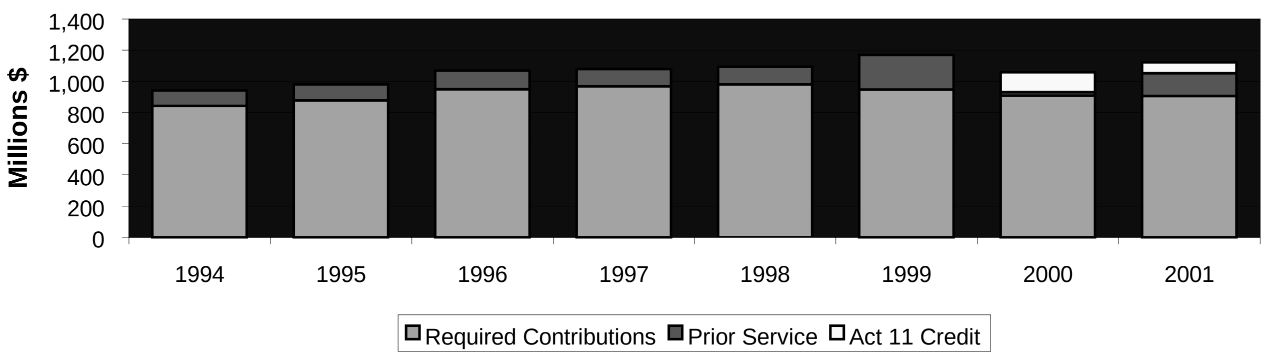
Pension Funds

Combined Pension Funds (Statement 1)
This statement combines the Fixed Retirement Fund, Variable Retirement Fund, and the Police & Firefighters Retirement Fund (s. 62.13).

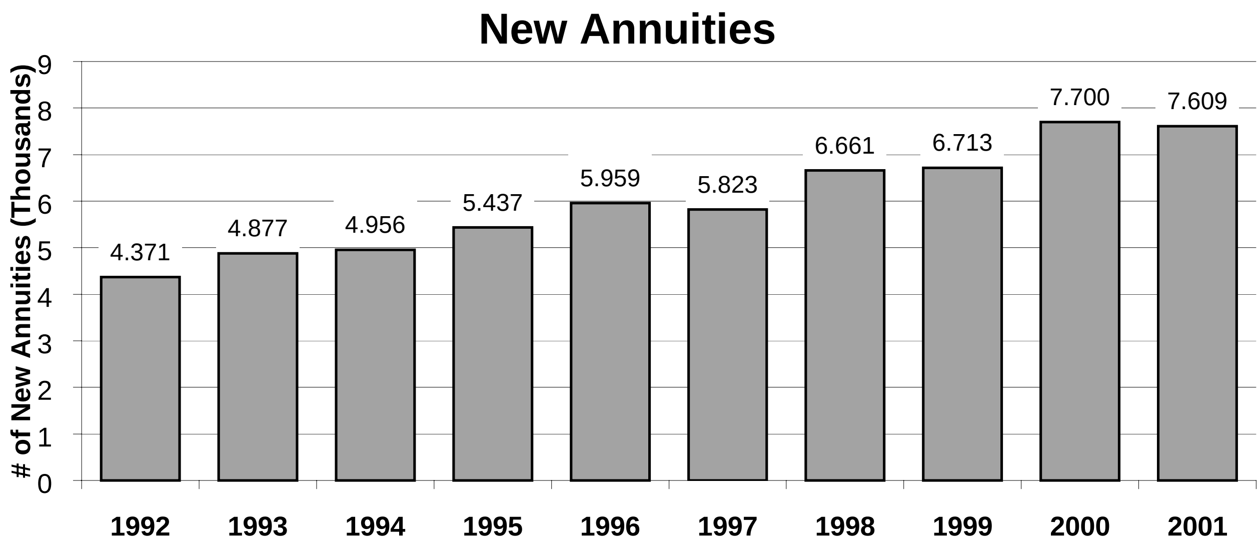
- **Contributions** – The most notable aspect of WRS contributions during 2000 and 2001 were the contributions which were not collected. 1999 Wisconsin Act 11 established a $200 million employer credit account which employers could use in lieu of making prior service contributions. These credit accounts offset approximately $128 million of contributions in 2000, and another $69 million in 2001. Only about $3 million in employer credits remained as of the end of 2001.

  The following chart shows the actual contributions received by year, as well as the contributions which were not collected because of the Act 11 employer contribution credits.

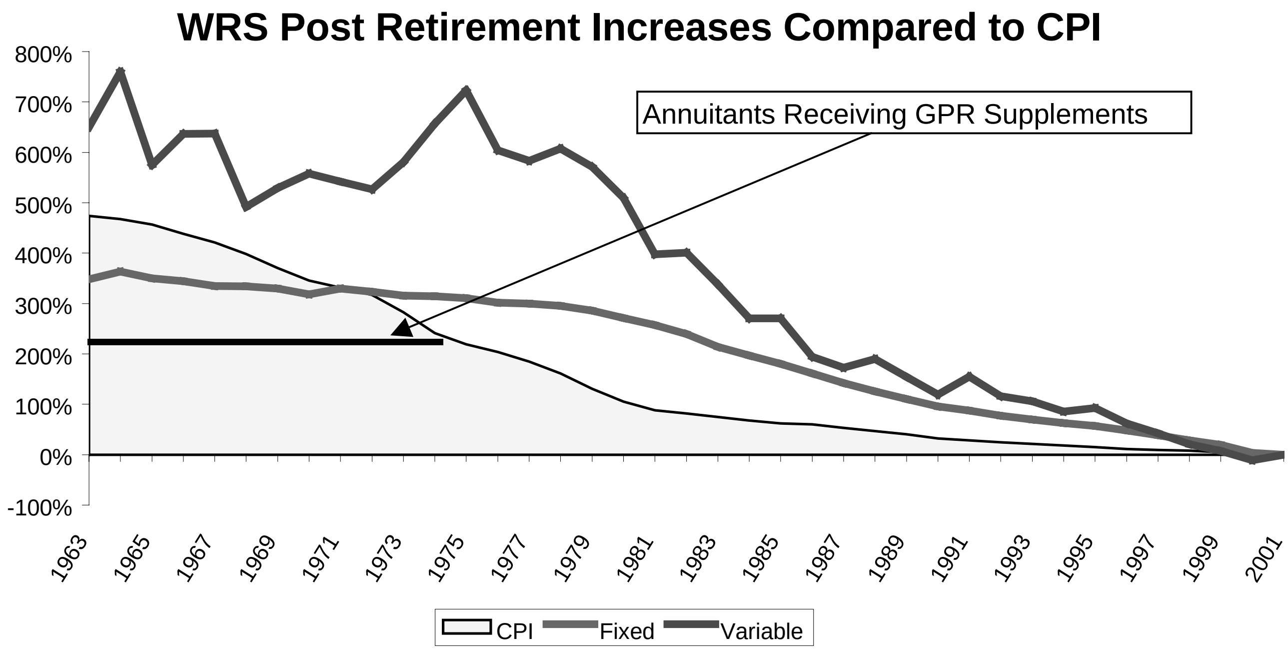
WRS Contributions



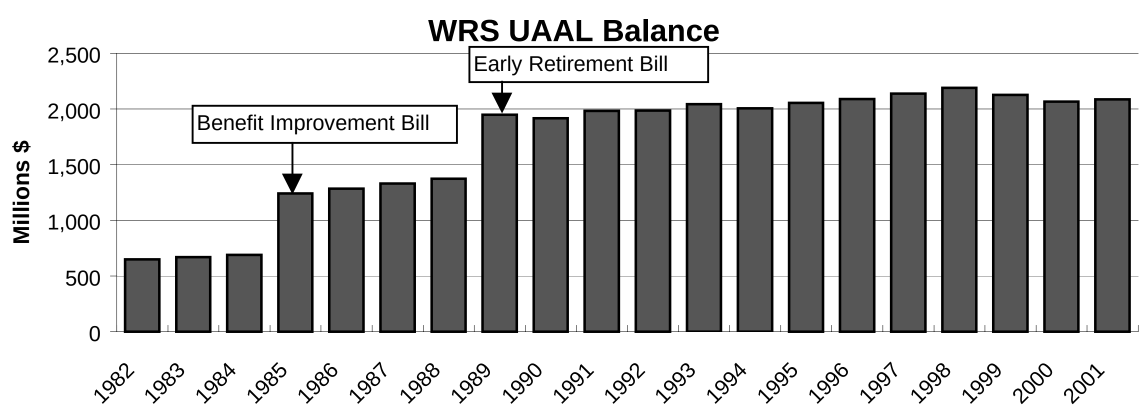
- **Annuity Benefit Payments** - Annuity benefit payments exceeded $2.4 billion in 2001, an increase of 11% over 2000. The fixed dividend of 5.7% and variable adjustment of minus 11.0% were significant factors in the increase in overall annuity payments. 7,609 new annuities were begun in 2001, down slightly from 2000. The 7,700 new annuities in 2000 was the highest number of new annuities ever initiated in one year.



The following chart shows the cumulative effect of post retirement annuity increases versus the cost of living (CPI-U) for the last forty years. The chart shows that cumulative fixed dividends have exceeded the cost of living for those annuitants retiring in 1972 and later. Cumulative variable annuity increases have exceeded the cost of living for annuitants who retired in every year since 1963, except those who retired in 2000. Those annuitants who began a variable annuity in 2000 had their annuity reduced by 11% in on April 1, 2001.

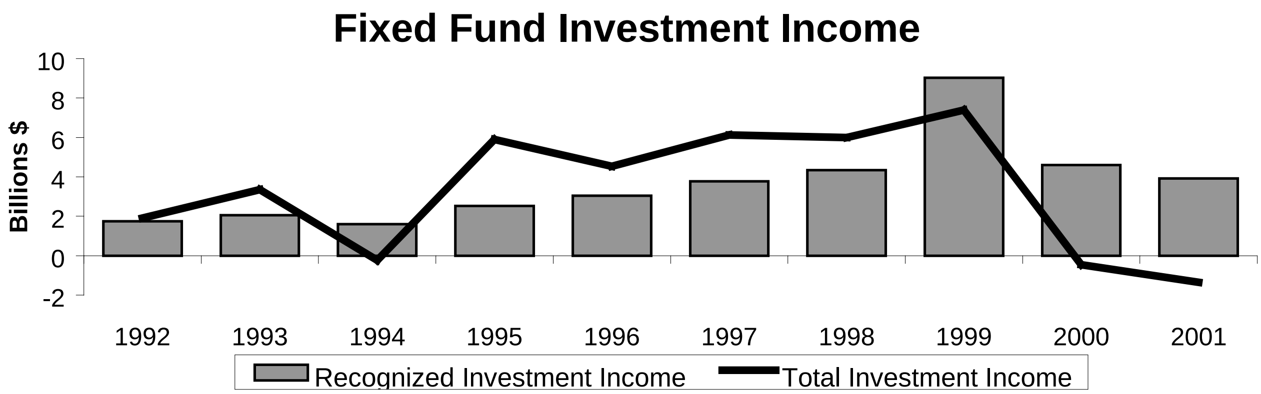


- **Prior Service Contributions Receivable** – This is the amount of the unfunded actuarial accrued liability (UAAL) due from employers. The balance of the UAAL increased slightly in 2001 because the interest assessed on outstanding balances is greater than payments being made by employers.



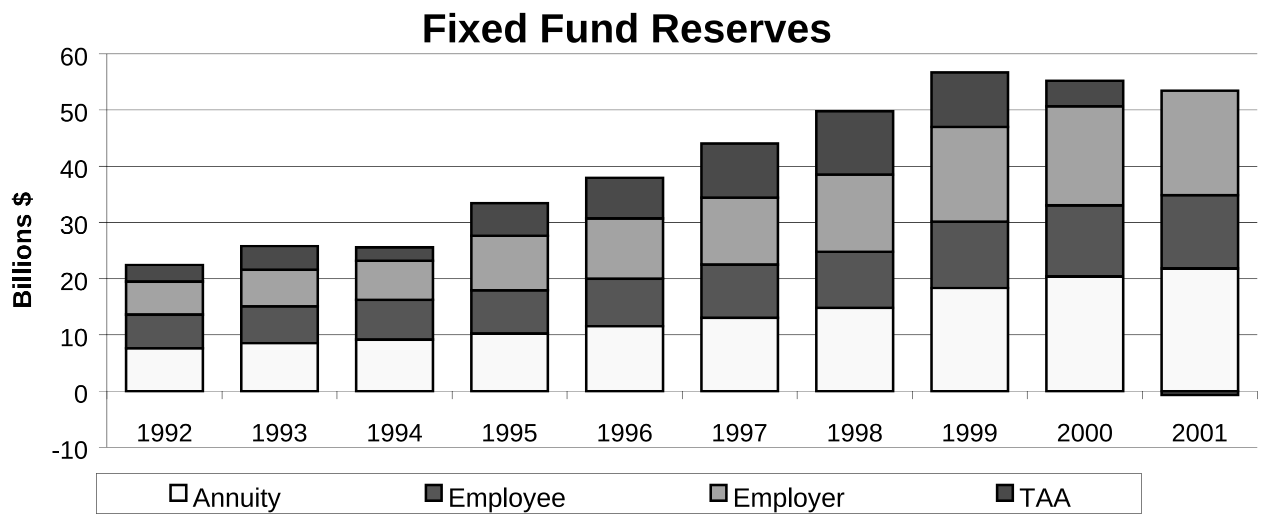
Fixed Retirement Fund (Statement 2)

- **Investment Income** - The report shows an investment loss of $1.4 billion in 2001. This is a combination of $3.9 billion recognized as current income, and $5.3 billion distributed from the transaction amortization account / market recognition account balance. The $3.9 billion current income resulted in a fixed effective earnings rate of 8.4% and fixed dividend of 3.3%. The chart below illustrates the relationship between total investment income earned and the investment income actually recognized in a year. In any year, the difference between total income and recognized income is the net addition to or distribution from the transaction amortization account.

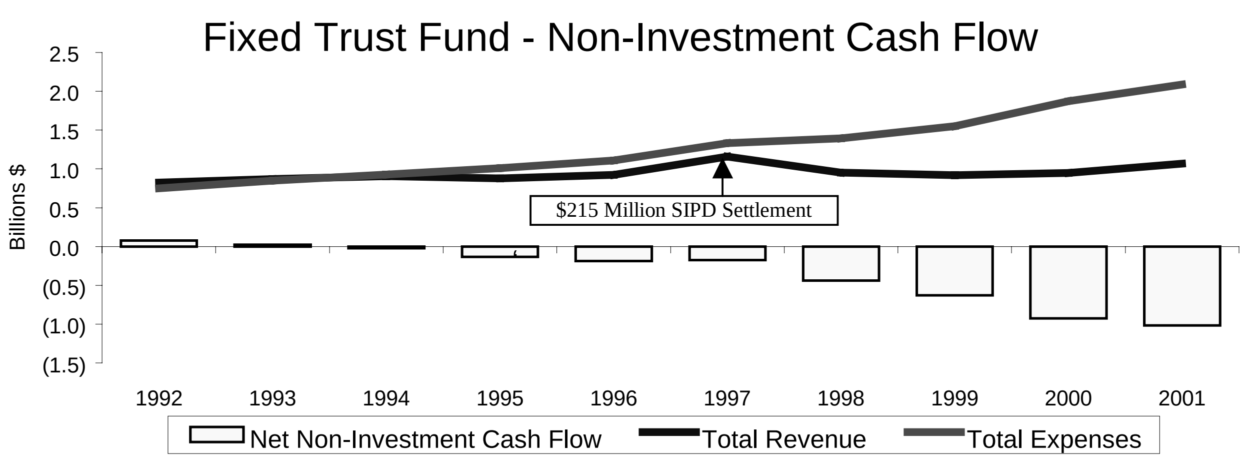


- **Act 11 Prior Service Write-Off –** 1999 Wisconsin Act 11 provided $200 million for a contribution “holiday” for WRS employers. Approximately $183 million of this amount was used to reduce amounts due to the WRS for UAAL payments. This is reflected in the financial statements as a write-off of amounts due to the WRS.

- **Total Fund Balance** - The total fixed retirement fund balance decreased by $2.5 billion, or 4.5% in 2001. This was a combination of a $1.4 billion investment loss and $1.1 billion of benefits and expenses in excess of contributions. The chart below shows the individual reserves making up the total fund balance. It is important to note that although the total Fixed Trust Fund balance has declined in each of the last two years, the individual annuity, employer and employee reserves have grown each year as the balance in the TAA has been distributed into the other reserves.



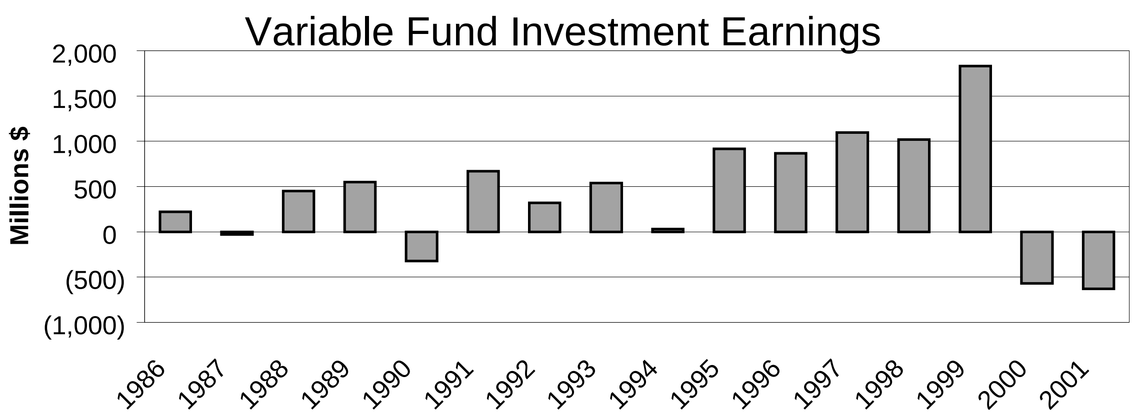
The chart below shows the non-investment related cash flows for the Fixed Trust Fund. Benefits and expenses first exceeded contributions in 1994, requiring the use of investment income to meet benefit obligations. By 2001, benefits and expenses exceeded contributions by $1.1 billion. It is expected that in approximately five years the cash flow required for benefit payments will exceed the income received from investments (interest and dividends) and investments will have to be liquidated to provide the necessary resources for benefit payments.



- **Reserve for Undistributed Earnings** - This reserve is the investment earnings that have not yet been distributed to participant accounts and reserves. Investment earnings are distributed to the fixed reserves in tenths of a percent. The Undistributed Earnings account balance of $34.8 million is less than 0.1% of reserves, and cannot be distributed. This balance will be added to the 2002 investment earnings and used in determining the 2002 effective earnings rate.

Variable Retirement Fund (Statement 3)

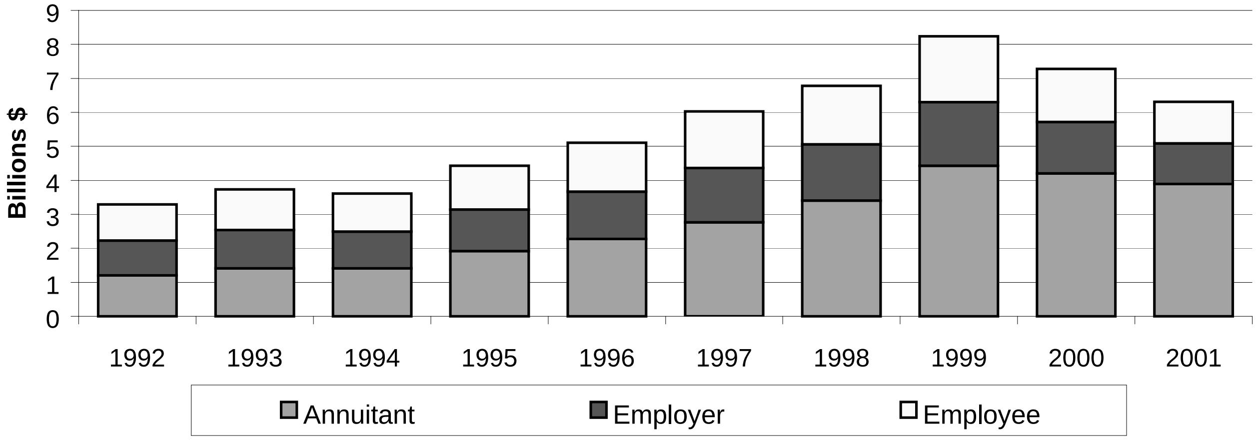
- **Investment Income** - Variable fund investments lost $630 million in 2001. This loss resulted in an effective rate of negative 9% for 2001 compared to the effective rate of negative 7% in 2000. The chart below shows the volatility of the variable fund investment income. While investment income in the variable fund is only slightly more volatile than the fixed fund, the absence of a smoothing mechanism, such as the TAA/MRA, results in the full volatility of the fund being passed directly to the reserves and the participants each year.



- **Contributions** - Contributions increased dramatically in 2001, reflecting the over 67,000 participants who elected to participate in the variable fund after the fund was reopened by Act 11.

- **Total Fund Balance** - The total variable fund balance decreased by over $980 million, or 13.1% in 2001. The decrease resulted from an investment loss of $630 million less $350 million in benefits and expenses in excess of contributions. The chart below shows the rapid decline in the variable fund during the market downturn of the last two years.

Variable Fund Reserves



- **Reserve for Undistributed Earnings** - This reserve is the accumulated investment earnings that have not yet been distributed to participant accounts and reserves. Investment earnings are distributed to the variable reserves in full percentages. The Undistributed Earnings account balance of $7.2 million is only 0.1% of reserves, and cannot be distributed. The balance will be added to the 2002 investment earnings and used in determining the 2002 effective earnings rate.

Police & Firefighters (Statement 4)
- No further explanation of the report.

Milwaukee Special Death Benefit (Statement 5)
- **Insurance Premiums** – The Milwaukee Death Benefit program was insured with a private insurance carrier beginning in 1998.

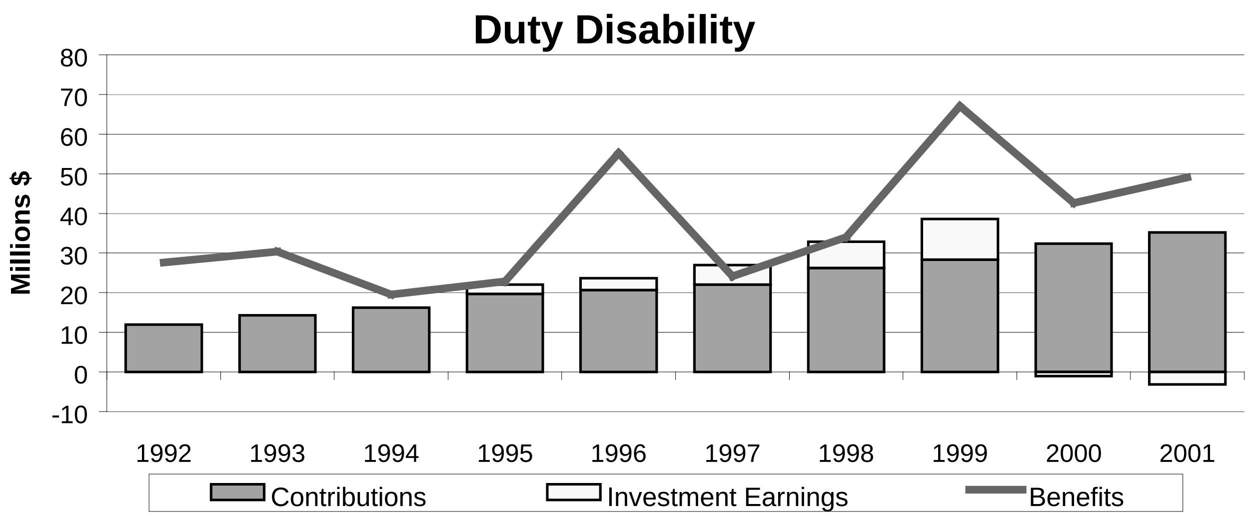
General Fund (Statement 6)
- **Annuity Benefit Payments** - Supplemental benefits paid to the oldest annuitants were $4.5 million in 2001, down from $5.4 million in 2000. Payments are expected to drop rapidly to approximately $3.7 million in 2002 and $3.1 million in 2003.

Insurance Funds

Duty Disability (Statement 7)
- **Contributions** - Employer contributions increased by 8.6% in 2001, and 194% since 1992. These increases are the result of contribution rate changes intended to eliminate the program's actuarial deficit. Duty Disability contribution rates are experience rated by employer, so new claims from an employer may result in increases in that employer's contribution rate.

- **Annuity Benefit Payments** - This expense is the actuarial value of all future benefit payments for disability claims incurred during 2001, not just the actual payments made during the year.

- **Estimated Future Claims** - This is the actuarial value of all future benefit payments for disability claims incurred during 2001 and prior years.



- **Total Fund Balance** - The fund balance deficit increased by 8.3% in 2001. In past years, investment income helped close the gap between contributions collected and benefits approved during the year. The investment losses in 2000 and 2001 have significantly increased the funding shortfall.

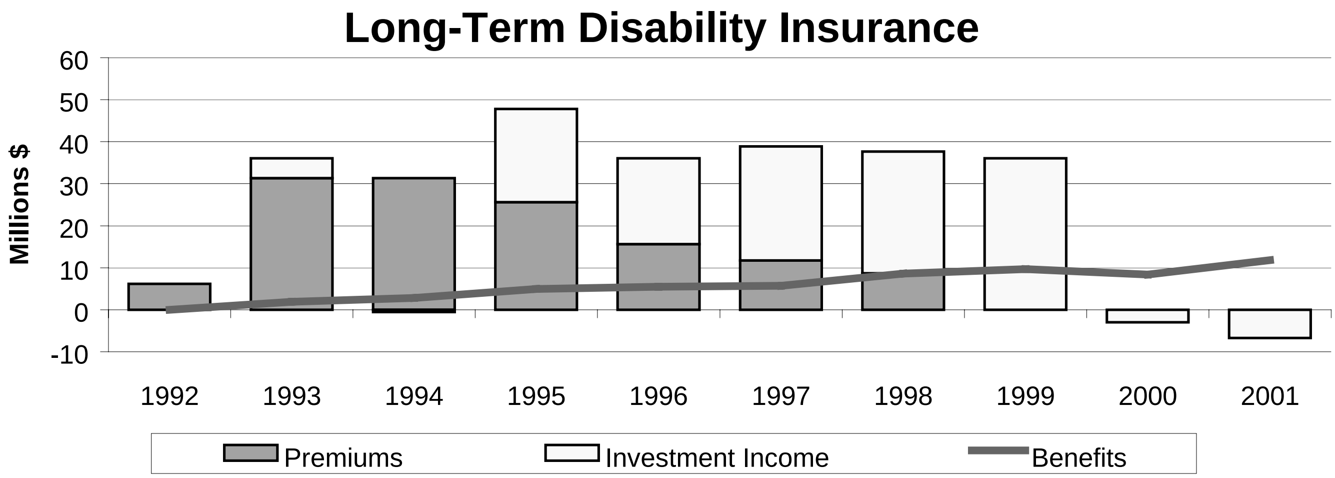
Long-Term Disability Insurance (Statement 8)

- **Contributions** - Contributions for LTDI are set by the actuary and collected from the Wisconsin Retirement System. No premiums are collected directly from employers or participants. Required contributions have been suspended since 1999 in recognition of the high overall funding level for the program.

- **Insurance Claims** - This expense is the actuarial value of all future benefit payments for disability claims incurred during 2001, not just the actual payments made during the year.

- **Estimated Future Claims** - This is the actuarial value of all future benefit payments for disability claims incurred during 2001 and prior years.

- **Total Fund Balance** - The LTDI fund balance declined by 8.4% in 2001. Despite this decline, the program remains extremely well funded. A rapid buildup of assets in the early years of the program assures that adequate reserves will be available for benefits as the transition from the existing WRS disability program to LTDI takes place.

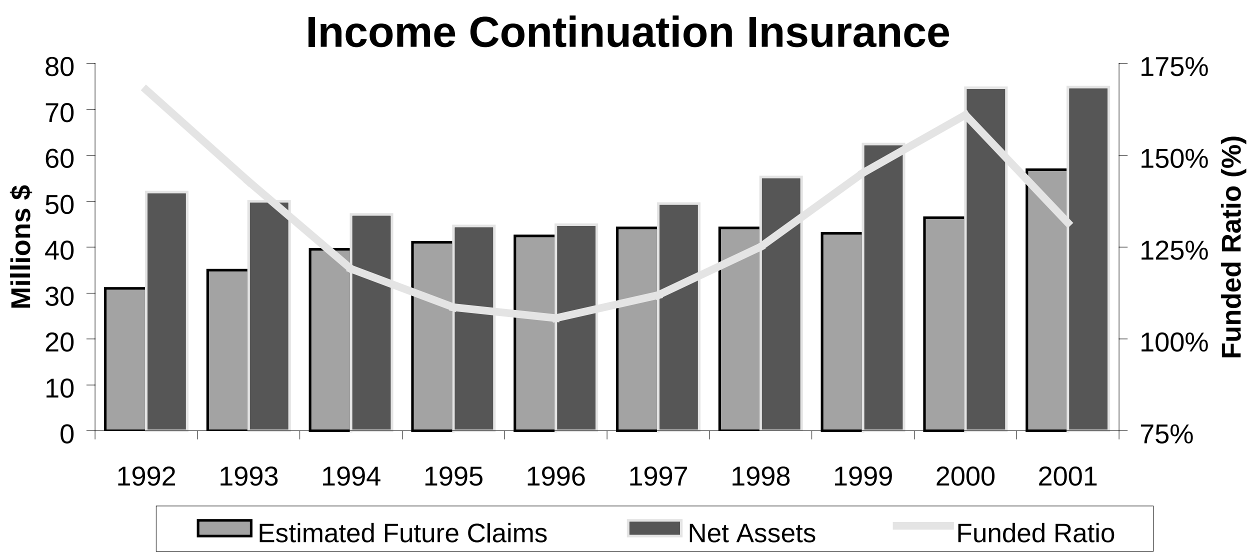


Income Continuation Insurance (Statement 9)

- **Insurance Claims** –This expense is the actuarial value of all future benefit payments for disability claims incurred during 2001, not just the actual payments made during the year.

- **Estimated Future Claims** - This is the actuarial value of all future benefit payments for disability claims incurred during 2001 and prior years.

- **Fund Balance** - The ICI unreserved fund balance declined sharply in 2001 as a result of significantly increased claims payments and the investment loss. Despite the decline, assets are still approximately 132% of liabilities. The funding objective for the ICI program is to maintain reserves between 100 and 125% of liabilities.



Health Insurance (Statement 10)

- No further explanation of the report.

Life Insurance (Statement 11)

- No further explanation of the report.

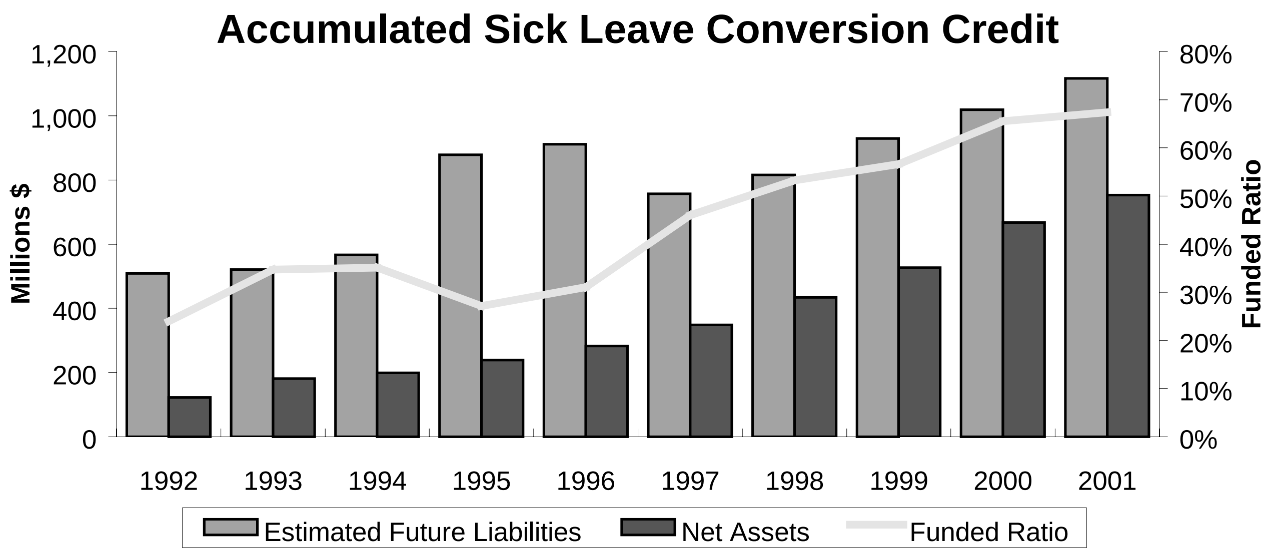
Other Benefit Plans

Employee Reimbursement Accounts (Statement 12)

- No further explanation of the report.

Accumulated Sick Leave Conversion (Statement 13)

- **Fund Balance** - While significant progress has been made in funding the accrued liabilities, actuarial estimates are that it will take 20 additional years to fully fund the program.



Deferred Compensation (Statement 14)

- **Investments** - Total investments declined by 4.0% during 2001. This amount was the sum of net new deferrals of $50 million less the investment loss of $99 million.

Administration (Statement 15)

- No further explanation of the report.